



## Nongrantor Trusts - Structuring Checklist

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### Significance.

If the proposed grantor trust provisions (§2901 and §1062) are enacted, future transfer planning will be with nongrantor trusts, and planners will have to structure trusts carefully so they are nongrantor trusts. Even if those provisions are not enacted, planners may want to structure trusts in some cases as nongrantor trusts. However, careful structuring of the trust agreement is not enough; trust administration should be monitored to assure that no actions are taken that would convert the trust (or a portion of the trust ) to a grantor trust (such as paying a premium of life insurance on the grantor's life). The following is a brief summary of planning considerations for structuring a nongrantor trust. (References to a Section or § are to the Internal Revenue Code of 1986, as amended.)

### Section 672(e) – Powers or Interests Held by Grantor's Spouse.

In applying all of the grantor trust rules, bear in mind that the grantor is treated as holding any power or interest held by (A) any individual who was the grantor's spouse at the time of the creation of such power or interest, or (B) any individual who became the grantor's spouse after the creation of such power or interest but only as to period after becoming the spouse. §672(e). The checklist below sometimes just refers to prohibitions on certain powers or interests of the grantor (if that is what the statute says), but observe in all those circumstances, such power or interest held by the grantor's spouse will be treated as being held by the grantor. Section 672(e) literally applies even after the spouse is divorced from the grantor, although the IRS has been requested (for example, by ACTEC following the repeal of §682) to interpret §672(e) in a narrower manner.

### Adverse Party – §672(a), Reg. §1.672(a)-1.

A number of the grantor trust rules depend on whether the consent of an adverse party to a particular action is required. An adverse party " means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." §672(a). "An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant." Reg. §1.672(a)-1(a). " Ordinarily, a beneficiary will be an adverse party," but the regulations provide various qualifiers to that general statement. Reg. §1.672(a)-1(b)-(d). Whether a person is adverse in any particular situation is necessarily a "facts and circumstances" matter, and some authorities suggest that the nature of family relationships in a particular situation may be considered. Accordingly, whether an adverse party's consent in a given situation is required may be subject to some degree of uncertainty.

### Section 674 Issues.

1. **General Rule, §674(a).** The general rule under §674(a) is that a trust is a grantor trust if anyone, including the grantor or grantor's spouse, has a power of disposition affecting beneficial enjoyment of the income or corpus without the consent of an adverse party. This general rule could be avoided by requiring the consent of an adverse party. Otherwise, one of the exceptions in §674(b)-§674(d) described below must be used to avoid grantor trust treatment.

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2. **Independent Trustee, §674(c).** Use an independent trustee (someone other than the grantor or grantor's spouse and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor) and give them the authority to distribute assets among a designated class of beneficiaries, §674(c).

A "related" party is a nonadverse party who is the grantor's father, mother, issue, brother, or sister. ("Unrelated" parties would include an aunt, uncle, niece or nephew, cousin, grandparent, or any of their spouses.) "Subordinate parties" are employees of the grantor or of corporations in which the combined voting power of the grantor and trust is "significant" or in which the grantor is an executive. Subservience to the wishes of the grantor is presumed unless shown otherwise by a preponderance of the evidence. §672(c).

3. **Trustee Other Than Grantor or Grantor's Spouse With Reasonably Definite Standard, §674(d).** Use a trustee other than the grantor or grantor's spouse, whose distribution powers over income, including accumulated income, are limited by a reasonably definite external standard, § 674(d). (Avoid providing that the trustee's discretion shall be "final and conclusive" or similar words. That might endanger whether the "reasonably definite external standard" is satisfied.)
4. **No Limit on Who is Trustee.** With no limitation on who is the trustee (including having the grantor or grantor's spouse as a trustee) meet the §674(b)(5) & 674(b)(6) exceptions.
  - a. **Corpus, §674(b)(5).** As to **corpus** use a reasonably definite distribution standard (or have separate shares for the beneficiaries), §674(b)(5).
  - b. **Income, §674(b)(6).** As to **income**, do not allow any sprinkling powers [that is KEY] and either—
    - (1) use a trust for a single beneficiary that ultimately must be paid to that beneficiary, her estate or to her appointees under a very broad limited power of appointment that does not exclude anyone other than her, her creditors, her estate, or the creditors of her estate (but the settlor may be uncomfortable giving the beneficiary that broad of a power of appointment), or
    - (2) provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, and for this purpose if a beneficiary dies before a distribution date that the beneficiary could reasonably have been expected to survive, the deceased beneficiary's share could pass to her appointees or to designated alternate takers (other than the grantor or grantor's spouse) in irrevocably specified shares (satisfying this option requires that the trust terminate in favor of a beneficiary on a date that is reasonably expected to occur during the beneficiary's lifetime), § 674(b)(6), or
    - (3) during the legal disability of the beneficiary or while the beneficiary is under age 21, the trustee can have the discretion to distribute income or to accumulate income and add it to corpus, §674(b)(7).
5. **Power to Add Beneficiaries.** No one other than an adverse party should have the power to add beneficiaries (that would be an exception to the §674(b)(5), §674(b)(6), §674(b)(7), §674(c), and §674(d) exceptions). For example, do not give a nonadverse party the authority to add the grantor (or grantor's spouse) as a potential discretionary beneficiary at a later time; this has been suggested as a planning alternative for "domestic asset protection trusts," to provide possible stronger asset protection (such person might never be added as a discretionary beneficiary if they never need any distributions from the trust), but do not give that authority to a nonadverse party if the trust is structured to be a nongrantor trust.
6. **Inter Vivos Power of Appointment.** Even if one of those exceptions is satisfied, also make sure that no one who is not an adverse party holds an inter vivos power of appointment. Section 674(b)(3) has an exception for testamentary powers but not inter vivos powers.
7. **Other Limited Application Exceptions.** Several other limited application exceptions apply regarding powers exercisable only after certain events, §674(b)(2), or powers to allocate among charitable beneficiaries, §674(b)(4).

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## Section 675 Issues.

1. **Power to Deal For Less Than Full Consideration, §675(1).** Prohibit anyone from dealing with trust assets for less than full and adequate consideration, §675(1).
2. **Power to Loan to Grantor For Inadequate Interest or Security, §675(2).** There should be no power to make a loan to the grantor or grantor's spouse without adequate security or adequate interest (other than a general lending power to make loans to any person without regard to interest or security), §675(2).
3. **Grantor Borrowing, §675(3).** The grantor or grantor's spouse should not actually borrow assets from the trust (or purchase assets from the trust for a note, *see* Rev. Rul. 85-13) at any time during the year, (but borrowing with adequate interest and adequate security will not cause grantor trust treatment if the loan is made by a trustee other than the grantor, grantor's spouse, or a related or subordinate trustee) §675(3).
4. **Non-Fiduciary Powers, §675(4).** No one (even an adverse party) should have a power, exercisable in a non-fiduciary capacity:
  - to vote or direct the voting of securities of a corporation in which the holdings of the grantor (or grantor's spouse) and the trust are significant (and there is no definition of "significant") from the viewpoint of voting control, §675(4)(A);
  - to control the investment of trust assets to the extent the assets consist of securities of a corporation in which the holdings of the grantor (or grantor's spouse) and the trust are significant, §675(4)(B); or
  - to substitute assets for equivalent value, §675(4)(C).

A power to vote or control investments in securities described in §675(4)(A)-(B) might arise, for example, with directed trusts (if the direction advisor acts in a non-fiduciary capacity) or possibly even if the manager of an LLC that owns such securities has the power to vote or control the investment of such assets.

## Section 676 – Power to Revoke.

No one other than an adverse party may have a power to revest in the grantor title any portion of the trust. §676.

## Section 677 Issues (Including Issues for a Nongrantor SLAT).

1. **Consent of Adverse Party, §677(a)(1).** If the grantor or grantor's spouse is a permissible beneficiary (i.e., income may be distributed or accumulated for his or her benefit), require the consent of an adverse party, §677(a)(1)-(2). (The adverse party's consent must be continued even after the grantor's death as to income, including capital gains, that are accumulated prior to the grantor's death, *see* Reg. §1.677(f).) Requiring the consent of an adverse party (which could be another current beneficiary or a first-level remainderman) raises (1) family dynamics issues and (2) potential gift tax issues if an adverse party consents to such a distribution that has the effect of diminishing the value of her own interest.
2. **No Spouse Interest Until After Grantor's Death, §677(a)(1).** If an adverse party's consent is not required, the grantor's spouse should not become a permissible beneficiary until after the grantor's death, and then only as to future income (not income and capital gains accumulated before death; perhaps the accumulated income and capital gains would be segregated into a separate trust because otherwise, tracing the portion of the trust assets attributable to accumulated income could be quite cumbersome). Perhaps someone could be given the authority to add the grantor's spouse as a discretionary beneficiary after the grantor's death (but not including any accumulated income), but that would raise the potential uncertainty of whether that is a power to add beneficiaries, which would negate some of the §674(b)-(d) exceptions.
3. **Life Insurance Premiums, §677(a)(3).** Prohibit the trust from paying any life insurance premiums on the grantor's life (if the trust is not expected to own such a policy for which future premium payments will be needed) or require the consent of an adverse party (e.g., [i] someone who cannot benefit from the insurance death proceeds or [ii] someone who is a mandatory income beneficiary whose distributions are

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reduced directly as a result of consenting to the use of income to make premium payments) to make premium payments with trust assets. The statute suggests that merely prohibiting the trustee from using income to pay premiums would be sufficient, but Letter Ruling 8839008 held that a trust that prohibited the trustee from using trust income to pay premiums was still a grantor trust as to premiums actually paid because the payment from fiduciary accounting principal of the trust was deemed to come from taxable income. (The trust is likely a grantor trust only as to the amount of taxable income used to make premium payments, see Rev. Rul. 66-313.) That's the state of the law, and unfortunately it leaves a considerable amount of uncertainty as to whether a trust that owns life insurance on the grantor's life is a nongrantor trust.

What can we do in a planning mode for structuring new ILITs (for which it is impractical to prohibit the trust from paying insurance premiums) or for modifying existing ILITs to best support the position that the trust is a nongrantor trust (realizing that there is not 100% certainty)? Perhaps the safest alternative is to plan the trust so that all it owns is the life insurance policy and non-income producing assets (such as cash in a non-interest bearing account) so that it will never have taxable income during the grantor's life and prohibit the trustee from using taxable income (including capital gains and accumulated income) to pay premiums. Other possible alternatives include: (i) require the consent of an adverse party to the payment of premiums, or (ii) structure the trust so that a third party other than the grantor, perhaps a sibling or parent, creates the trust and the insured loans assets to the trust at commercially reasonable rates to make the premium payments.

### Section 679 Issues.

1. **U.S. Resident as Grantor.** If a U.S. resident person is the grantor and if there is a U.S. resident beneficiary of any portion of the trust, avoid having one-half or more of the trustees who are not U.S. citizens or residents or a U.S. domestic corporation, §679, §677(a), §7701(a)(30)(E) & (31)(B).
2. **Non-U.S. Resident as Grantor.** A trust created by a non-U.S. resident for income tax purposes is a nongrantor trust (unless one of the limited exceptions in §672(f)(2) are satisfied). Being classified as a nongrantor trust in this context is generally undesirable for various tax reasons. Section 679 treats a foreign trust with U.S. beneficiaries as a grantor trust when the grantor becomes a U.S. resident if the grantor becomes a U.S. resident within five years of the contribution to the trust.

### Savings/Interpretation Clause.

Consider including prohibitions on any actions that would cause the trust to be a nongrantor trust, treating such actions as void ab initio. Make clear the grantor's intent that the trust is a non-grantor trust and that the trust should be interpreted in that manner.

### Trustee Changes.

Be *very* careful when trustee changes are made, due to trustee resignations or otherwise. Carefully review the provisions of §674 to assure that an exception to the general rule of §674(a) applies in all circumstances (as to both income and principal).

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